Chapter 3

What Is Money?

Meaning of "Money"

- Common uses of the word "money"
  - currency (banknotes and coins)
  - wealth (all property that serves to store value)
  - income (the flow of earnings per unit of time)

- Economists' meaning of "money" is *stock*
  - anything that is generally accepted in payment for goods and services
  - not the same as wealth or income

Functions of Money

1. *Medium of exchange* = used to pay for goods and services

   - it reduces transaction costs (vs. a barter economy)
   - a commodity can be used as money if:
     - is easily standardized
     - is widely accepted
     - is divisible
     - is easy to carry
     - does not deteriorate quickly

Functions of Money (cont.)

2. *Unit of account* = prices are expressed in terms of the same unit,

    - allows the comparison of goods in terms of cost (price)

    - reduces transaction costs – no need for pairwise prices

3. *Store of value* = allows the intertemporal transfer of purchasing power

    - not that much in case of (hyper)inflation

Evolution of Payment Systems

- precious metals like gold and silver – heavy, so hard to transport

- paper currency (fiat money) – easy to steal

- checks – not that fast to travel to different locations (so funds are not immediately available), costly to process

- electronic means of payment – online bill-pay

- electronic money: debit cards, stored-value cards (e.g., prepaid phone cards), smart cards, e-cash

Federal Reserve's Monetary Aggregates

- Monetary Aggregates, most liquid first:
  - *M1* = assets that can be clearly used as medium of exchange (like-cash assets, checking accounts)
  - *M2* = adds onto M1 assets on which checks can be written or other assets that can be turned into cash fast and at very little cost (e.g., savings accounts)
  - *M3* = adds onto M2 less liquid assets

Federal Reserve's Monetary Aggregates – Example

Table 1 Measures of the Monetary Aggregates

	Value as of December 2002 ($billions)
M1 = Currency	626.5
+ Traveler's checks	7.7
+ Demand deposits	290.7
+ Other checkable deposits	281.2
Total M1	1,206.1
M2 = M1	
+ Small-denomination time deposits and repurchase agreements	1,332.3
+ Savings deposits and money market deposit accounts	2,340.4
+ Money market mutual fund shares (noninstitutional)	923.7
Total M2	5,802.5
M3 = M2	
+ Large-denomination time deposits and repurchase agreements	1,105.2
+ Money market mutual fund shares (institutional)	767.7
+ Repurchase agreements	511.7
+ Eurodollars	341.1
Total M3	8,528.2

Source: www.federalreserve.gov/releases/h6/hist.

Note: The *Travelers checks* item includes only traveler's checks issued by non-banks, while traveler's checks issued by banks are included in the *Demand deposits* item, which also includes checkable deposits to businesses and which also do not pay interest.

Growth Rates of Fed's Monetary Aggregates
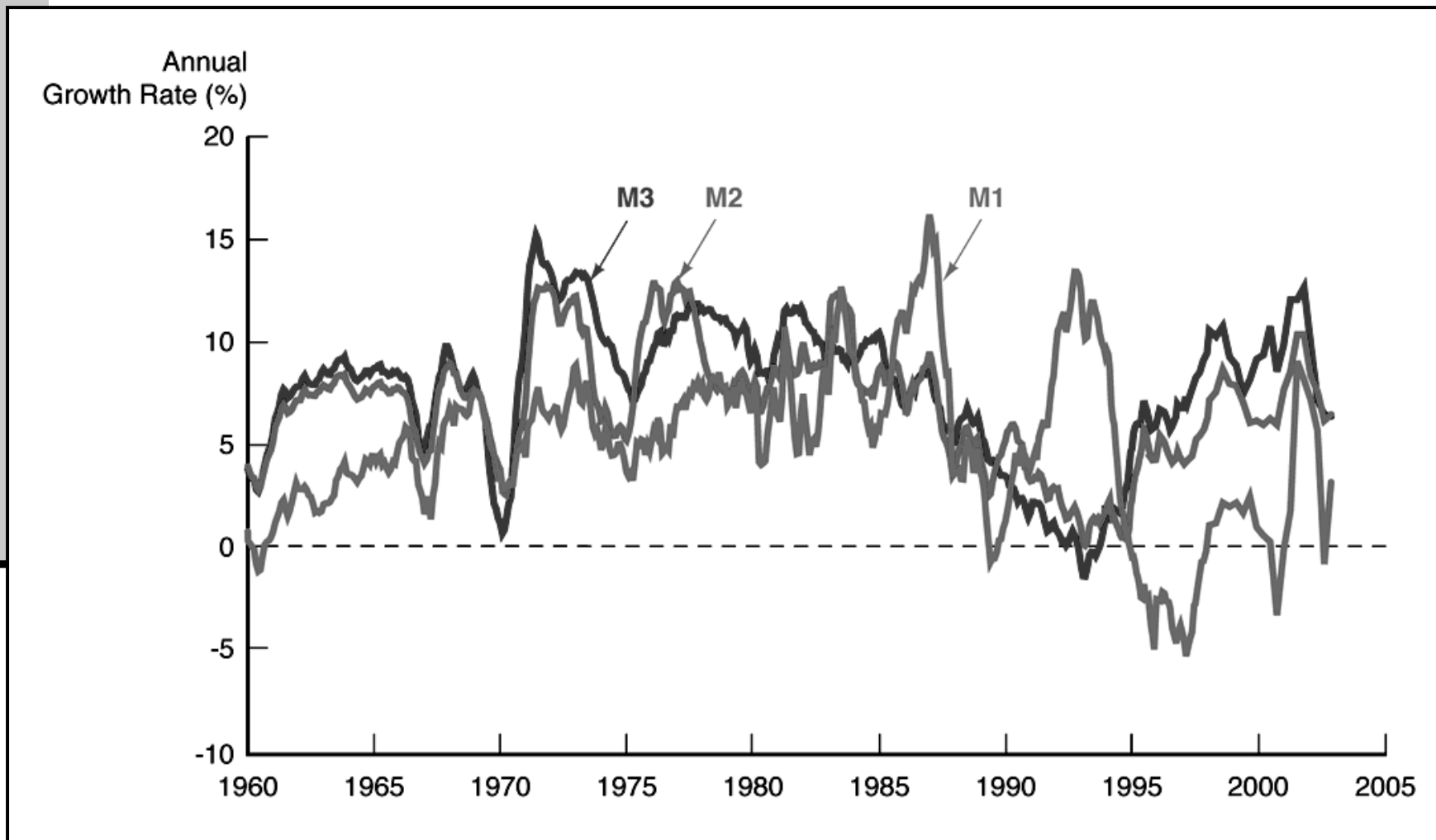
How Reliable Are M2 Money Data: Data Revisions

Table 2 Growth Rate of M2: Initial and Revised Series, 2002
(percent, compounded annual rate)

Period	Initial Rate	Revised Rate	Difference (Revised Rate − Initial Rate)
January	2.2	5.4	3.2
February	6.8	8.7	1.9
March	−1.4	0.2	1.6
April	−4.0	−2.6	1.4
May	14.8	15.4	0.6
June	7.6	7.1	−0.5
July	13.6	11.0	−2.6
August	9.9	8.6	−1.3
September	5.1	5.7	0.6
October	10.9	8.3	−2.6
November	10.2	8.0	−2.2
December	2.8	2.8	0.0
Average	6.5	6.5	0.0

Source: Federal Reserve Statistical Release H.6: www.federalreserve.gov/releases/h6.